

## Internal Revenue Service

Department of the Treasury

Number: **200240038**  
Release Date: 10/4/2002  
Index Number: 1362.02-02

Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:

PLR-115694-02 CC:PSI:3

Date:

June 27, 2002

### LEGEND

Company =

ESOP =

Trust =

State =

Business =

a =

b =

c =

d =

Dear :

This letter responds to a letter dated March 6, 2002, and subsequent correspondence, submitted on behalf of Company requesting a ruling that Company's subchapter S election will not terminate under the circumstances described below.

### FACTS

Company was incorporated under the laws of State on a, and engages in Business. Company established an employee stock ownership plan, the ESOP, effective as of b. Pursuant to the terms of the ESOP, Company established an employee stock ownership trust, the Trust, to hold Company stock. On c, the Trust purchased all of the outstanding stock of Company, thus becoming the sole owner of

Company stock. Following this stock purchase, Company elected to be treated as a subchapter S corporation, effective as of d.

Under the terms of the ESOP, distributions may be made to plan participants in the form of cash or Company stock. However, as long as Company has an S election in effect, a participant who receives Company stock must provide prior written notice of the participant's intent to sell the stock to Company immediately upon distribution. The terms of the ESOP also provide that every participant who receives a distribution may direct that the distribution be paid directly to an individual retirement account ("IRA"), or another qualified retirement plan as required under § 401(a)(31) of the Internal Revenue Code ("a direct rollover"). Alternatively, a participant who receives and sells Company stock to Company generally may, within 60 days, roll the proceeds over to an IRA or qualified retirement plan (an "indirect rollover").

In either a direct or indirect rollover, in the case of a stock distribution, a participant, in the participant's capacity as the beneficiary of the IRA account, will complete an irrevocable stock transfer form. The irrevocable stock transfer form is prepared specifically for each distributee and identifies the number of shares to be sold to Company immediately following the distribution from the ESOP. Company prepares a check for each distributee and records the stock transfer to the distributee and redemption by Company on its stock record books. Because the stock distribution and the repurchase of the stock occur on the same day, a stock certificate never leaves Company's premises. Company represents that by monitoring the timing of stock distributions from the ESOP, Company can ensure that it will never have more than 75 shareholders.

Company has requested a ruling that its status as an S corporation will not terminate if the ESOP makes distributions of Company stock, and one or more participants elect to make a direct rollover of the distribution to an IRA, provided that the stock is immediately repurchased by Company using the procedure described above.

#### LAW AND ANALYSIS

Section 1361(b)(1)(B) provides that an S corporation may not have as a shareholder a person that is not an estate, a trust described in § 1361(c)(2), an organization described in § 1361(c)(6), or an individual.

Section 1361(c)(6) provides that for purposes of § 1361(b)(1)(B), an organization that is described in § 401(a) or 501(c)(3), and is exempt from taxation under § 501(a), may be a shareholder in an S corporation. Under § 1361(c)(6), an employee stock ownership plan is an eligible shareholder of an S corporation provided that the employee stock ownership plan is described in § 401(a) and is exempt from tax under § 501(a). According to Rev. Rul. 92-73, 1992-2 C.B. 224, an IRA is not permitted to hold stock in an S corporation.

Section 401(a)(31) requires a § 401(a) plan to permit participants to elect to have an eligible rollover distribution paid directly to an eligible retirement plan specified by the participant. Section 402(c)(4) provides that the term “eligible rollover distribution” is defined as any distribution to an employee of all or any portion of the balance credited to his or her account in a qualified trust, except for distributions made in the form of an annuity or in installments over a period of ten years or more. Section 402(c)(8)(B) provides that the term “eligible retirement plan” is defined to include IRAs.

Under § 409(h)(1)(A), an employee stock ownership plan generally is required to make distributions available in the form of employer securities. However, § 409(h)(2) provides, in pertinent part, that an employee stock ownership plan maintained by an S corporation may provide that benefits will be distributed in the form of cash. Alternatively, § 409(h)(2) provides, in pertinent part, that benefits from an S corporation employee stock ownership plan may be distributed in the form of employer securities subject to the requirement that the securities may be sold back to the sponsoring employer under a fair valuation formula.

Employee stock ownership plans, IRAs, and S corporations are all subject to significant qualification rules. As described above, the terms of the ESOP provide that distributions may be made to plan participants in the form of cash or Company stock, but that as long as Company has a subchapter S election in effect, Company must immediately purchase any distributed stock. Distributions of cash and stock both may constitute eligible rollover distributions that qualify for direct and indirect rollovers. Whenever a distribution of stock (subject to immediate repurchase by Company) is rolled over to an IRA, the custodian of the IRA receives the proceeds of the repurchase. Thus, every direct or indirect rollover (whether of stock or cash) to an IRA results in the custodian of the IRA receiving cash for the benefit of the plan participant. In the case of a direct rollover of stock, the momentary designation of the custodian of the IRA as the owner of the stock under the particular facts described above will not cause Company's S election to terminate.

### CONCLUSION

Based solely on the facts submitted and the representations made, we conclude that Company's S corporation election will not terminate if the ESOP makes distributions of Company stock and one or more participants elect to make a direct rollover to an IRA, provided that the stock is immediately repurchased by Company using the procedure described above.

Except for the specific ruling above, we express or imply no opinion concerning the federal tax consequences of the facts of this case under any other provision of the Code. Specifically, we express or imply no opinion regarding whether Company is qualified to be an S corporation or whether the ESOP constitutes a qualified plan under § 401(a).

Pursuant to a power of attorney on file with this office, a copy of this letter is being sent to Company's authorized representatives.

This ruling is directed only to the taxpayer requesting it. Under § 6110(k)(3), it may not be used or cited as precedent.

Sincerely yours,  
/s/

MARY BETH COLLINS  
Senior Technician Reviewer, Branch 3  
Office of the Associate Chief Counsel  
(Passthroughs and Special Industries)

Enclosures (2):  
Copy of this letter  
Copy for § 6110 purposes

PLR-115694-02

5

cc: